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Testimony
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Unites States House of Representatives

"A Balancing Act: Cost, Compliance, and Competitiveness after Sarbanes-Oxley"

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I would like to first express my appreciation for the opportunity to speak before the Subcommittee on Regulatory Affairs and share my views with regard to the costs and benefits of Sarbanes-Oxley. This is an issue of great importance to small businesses in America as well as to the financial community, regulators, and others who provide services to this vital segment of the American economy.

I am speaking before the Subcomittee from a dual perspective: first, as President, CEO & owner of an NYSE and NASD member firm that has small business issuers (SBI's) as clients, and secondly, as an individual who has invested personally in many SBI's and has also acted as an officer and director of SBI's.

Unintended Consequences: Decreased Liquidity & Competitiveness of U.S. Markets

I have been working with SBI's for over twenty years, and have witnessed numerous changes in regulations that have significantly improved the transparency of small cap markets, particularly the OTC Bulletin Board (OTCBB). While some of these regulations placed increased burdens on issuers, they were regulations aimed specifically at smaller issuers for the purpose of enhancing disclosure and market liquidity for smaller public companies. By contrast, the Sarbanes-Oxley Act (SOX) has placed a broad-based burden on public company issuers of all shapes, sizes, and characteristics. While there are many positive aspects of the Act, such as those regarding conduct and related-party transactions, the audit and review standards are particularly onerous. In the case of larger companies, I believe the burden can be absorbed with reasonable impact and the benefits are realized by a large number of investors. In the case of smaller public companies, however, I believe the cost, in terms of both financial impact and management resources, has a disproportionately large effect. These impacts and expenses are not commensurate with the benefit received, resulting in two trends that are having a negative effect on capital formation for small companies in the U.S.:

- Many issuers are choosing to terminate their registration, or "go dark"
- An increasing number of issuers are choosing to go public in markets outside the U.S.

Both of these fall under the "law of unintended consequences", having an effect that is the exact opposite of what SOX attempts to accomplish. Rather than increasing disclosure and providing stronger controls for companies, many issuers are terminating previously available disclosures, or, by going public elsewhere, not providing them at all.

According to a study at the University of Maryland, approximately 200 companies petitioned to delist their stock in 2003, with an estimated similar number in 2004. This compares with just 67 companies in 2002, prior to the implementation of SOX. Considering there are approximately 5,000 issuers on the Nasdaq Capital Market, American Stock Exchange (Amex) and OTCBB markets combined, which is where I would assume the brunt of these de-registrations were felt, this implies a loss of about 4% of smaller companies from the public arena per year. I cannot begin to estimate the number of individual investors affected by this, but I expect that the number is vast. Short of taking costly legal action against the issuer and further burdening our court system, investors in such a situation have little recourse. Their securities are either moved to the pink sheets where they frequently trade at a fraction of their prior price, or they stop trading altogether and pricing becomes subject to the whims of a few large shareholders or management who may offer to repurchase their shares at a steep discount. As the investors are left in the dark, having significantly less knowledge about the actions of management and operational results of the company, they are left with little leverage with which to form the basis of a more accurate valuation.

The second trend is the growth of competing, non-U.S. marketplaces catering to small cap companies, particularly the Alternative Investment Market (AIM) in London. The number of foreign companies listed on the AIM has nearly doubled each year since 2003, when SOX was first implemented. With only 60 foreign companies listed on AIM in 2003, the number jumped to 116 in 2004, 220 in 2005, and 262 through May of this year. By contrast, the number of Nasdaq Capital Market issuers has declined by 129 from December 2003 to date, an 18% decline, while OTCBB issuers have declined by 243 (6.8%) over the same time period. The one bright spot is Amex, which gained 159 issuers from December 2003 to date, although this still nets to a loss of 213 across the three markets – nearly identical to the number of foreign issuers on the AIM.

Among its listed companies, the AIM includes 35 U.S. companies, up from 17 one year ago. Some of these abandoned their U.S. trading status in order to join the AIM; some never pursued U.S. trading at all. Our own investment banking clients, including Chinese, Eastern European, and even U.S. issuers, have requested that we consider the AIM as an option for them as an alternative to U.S. markets. In fact, one of our former clients is now listed on the AIM after opting against the U.S. markets. Additionally, our customers that invest in small cap stocks are increasingly trading in non-U.S. markets and expressing interest in making direct investments into companies traded in non-U.S. markets. Further emphasizing this attraction is the fact that newer markets are being formed that are emulating the AIM, rather than Nasdaq. In the past year the Irish Stock Exchange launched the Irish Enterprise Exchange, the European Euronext market launched the Alternext market, and Deutsche Borse launched the Entry Standard market, each focused on small-cap companies. As these alternatives become increasingly available and credible, issuers, both U.S. and international, will have less incentive to face the complexities and costs of trading on comparable U.S. markets.

Costs and Benefits: Perceptions of Issuers and Investors

The two trends presented above reflect the general push back smaller public companies are having against SOX. While many smaller public companies are choosing to stay the course and comply with the newer regulations as they become applicable to them, there is significant discontent and concern regarding the disproportionately high cost to them. A study by Foley & Lardner LLP ("F&L") found that for FY 2005 the percentage increase in average audit fees was significantly higher for small cap (22%) than mid cap (6%) and S&P companies (4%). The year-to-year percentage increases were greatest during phase-in of Section 404 requirements, with the largest increases being felt by small cap companies.

In preparation for this testimony, we surveyed smaller public companies, which I define as companies with market capitalization and revenues below $100 million[1], to get feedback regarding their experience with SOX. Of the 36 responses, the companies had average market capitalization of $28 million and revenues of $22 million and trade primarily on the AMEX, OTCBB, and Pink Sheets. The vast majority of the survey group had not yet implemented Section 404, but expected to do so in the next two years. Of those surveyed, approximately 70% felt that SOX had no effect on communications with shareholders, communications with analysts, or other information useful to management. 67% of those surveyed also felt the quality of their financial reporting was the same, although 31% did feel it had improved since the implementation of SOX. 74% believed that the results obtained were not worth the expense and effort in implementing them. This closely mirrors the 82% of respondents to F&L's study who felt that corporate governance and public disclosure reforms are too strict.

In addition to the direct costs of compliance, many companies felt indirect costs to their overall business. 35% of our survey respondents felt that SOX compliance took management time and attention away from managing their business, while 81% had to hire additional staff or outside consultants to comply with SOX. F&L's study found that 34% of respondents had to make budget and/or staffing cuts in critical areas of their business to accommodate their SOX budget and requirements.

As an additional gauge of perception of the effects of SOX, we surveyed investors, including 27 individual and institutional investors. We asked these investors about the effects of SOX on the small and micro cap companies they invest in or would like to invest in. While 33% of the survey group believed SOX had the potential to reduce the risk of management fraud, 56% believed it had no effect. Almost the entire group, 93%, felt that SOX had a negative effect on issuer profitability, and 100% believed SOX has caused small and micro cap companies to be less likely to go public in US markets. When rating the effect of various factors on positive share price performance, 85% felt earnings and revenue growth was most important, while 85% felt compliance with SOX was least important. This indicates that, while investors find there are some positive aspects to SOX, these aspects are not as highly valued in the marketplace in light of the negative impact on profitability.

[1] While Small Business Issuers are currently defined by the SEC as companies with less than $25 million in annual revenues, I believe this number is out of date given the effects of inflation, the general increase in market valuations over the years, as well as the increased costs of being a public company as a result of SOX, which represent significant costs to companies much larger than the $25 million current standard.

The Impact of Section 404

It is certainly well documented that Section 404 has been the most contentious aspect of SOX. As I stated earlier, I do believe SOX has many positive aspects, including the formation of the PCAOB, increased auditor independence and more direct corporate responsibility on executive officers and directors. Additionally, many of the financial disclosures required by Section IV of the Act, such as greater disclosure of related party transactions and more frequent SEC review of periodic disclosure reports, greatly enhance investor protection in the U.S. However, Section 404 specifically is counterproductive in two ways:

- Taking management time and attention away from managing its business
- Creating a contentious relationship between management and outside auditors

Under Section 302 of SOX, each issuer's principal executive officer and principal financial officer takes responsibility for the contents of every periodic report filed by that issuer, including the financial statements and internal controls. As a result of this section, it is of course in the best interests of such officers to implement appropriate controls to ensure their results of operations are properly recorded and reported. Each of these officers are intimately familiar with the workings of their own business, and therefore are in the best position to evaluate whether their controls are appropriate. Under Section 404, these officers would be required to spend significant time explaining their procedures to an outside auditor with limited knowledge of their business, and be forced to defend them against as yet undefined standards of effectiveness. This time could be much better spent on the implementation, rather than explanation, of these procedures, as well as nurturing suitable growth for the company within the boundaries of the procedures.

The auditor's limited knowledge of an issuer's business further makes Section 404 a very risky proposition for the auditor. While an auditor's role is key in advising a company with respect to the proper preparation of financial statements, application of financial guidelines, and disclosures with respect to financial statements, the evaluation of internal controls is an area outside of an auditor's training. The U.S. is a wonderful economy, nurturing of companies of all shapes and sizes. Consequently, entrepreneurs have developed countless different methods of managing their companies in a method that is appropriate for their organization. Some companies believe in a more centralized management system, others more decentralized, while others defy definition. The internal controls appropriate to an organization derive directly from their management style – whether they want each accountant to report directly to the CEO, assign a team leader to groups of employees, or create a chain of command through 5 departments. To ask an outside auditor to evaluate a company's internal controls is to ask them to evaluate that company's business culture and structure. Given that there are no by-the-book ways to test this, auditors are being given a nearly impossible task, which can easily result in disagreements with management, thereby impeding upon the auditors' most significant task – the audit of financial statements.

Conclusion

I suggest to the Committee that the benefits SOX intended to bring to America's capital markets are greatly weakened or even removed by the migration of small companies away from U.S. public markets. For those companies that remain, the increased costs and management time associated with some of the more onerous provisions of the Act, particularly Section 404, have had a negative effect on financial and operational performance, making these companies less competitive in the global marketplace.

SBI's are the companies with the greatest potential for growth, that create the most jobs and fuel our economy. While there are risks and failures among them, they also offer the highest returns over time, and they often grow into larger cap companies or become acquired by larger cap companies, thereby fueling additional growth. If we do not nurture our SBI's during their incubation period, we will continue to lose our unique level of innovation to markets outside of our borders.

Closing Remarks

In closing, I continue to believe that the U.S. has the best, most transparent markets in the world. That said, I believe we need to repair some of the stigma that foreign issuers in particular have against SOX by showing our willingness to adopt standards that are appropriate for different types of issuers. In view of the benefits that small businesses bring to America and its financial markets, Congress and the SEC should find ways to stem the tide of companies away from U.S. public markets without losing the investor protection these markets confer. While I understand that these are complex matters which should not be entered into lightly, I believe it is essential that necessary changes be adopted quickly in order to remove the uncertainty that currently hangs over our small cap markets.

Thank you again for the opportunity to express my views.